Addressing Weaknesses in Market Foundations - an International Perspective

Note by the FSF Secretariat for the 20-21 October High-level Roundtable in Basel

I. Introduction and Context

The accumulation of accounting irregularities and breakdowns in the chain of internal and external "checks and balances" on publicly listed companies is undermining investor trust in financial market foundations. The sensitivity of investors to negative corporate news has reached high levels and spread beyond the high-tech sector into national and international markets, exacerbating the financial and psychological impact of the bursting of the high-tech bubble. Indeed, symptoms of a crisis of confidence are present, even if it may be difficult to disentangle precisely what, in the current market re-pricing, is due to normal market corrections after a bubble, generalised suspicion over financial reporting and corporate governance or even doubts over the robustness of official baseline macroeconomic scenarios.

The turbulence associated with this loss of confidence has not so far raised financial stability concerns. Yet, financial stability problems may develop should weak financial markets threaten the recovery and further test the financial sector's resilience. Beyond the direct impact of the erosion of financial wealth, doubts about the reliability of corporate earnings are affecting lenders' and investors' appetite for risk, resulting in an increase in the cost of or reduced access to capital for corporations. Putting in place a set of structural reforms that will address the loss of investor confidence in a convincing way is therefore a key objective in all major financial centres.

The fact that the current crisis of confidence coincides with the cyclical unwinding of a bubble and associated uncertainty about the underlying real economic trajectories of key world economies, generates a clamour for quick fixes, on the notion that reforms of market foundations should somehow restore asset values. This is not a realistic objective, nor are expectations that the full effect of these reforms will be immediately felt. The challenge for national authorities and market participants is to manage this tension between public expectations and the careful work required to put in place a sounder framework of market foundations that will be effective for the long term.

Recent events have already prompted significant reactions by public authorities– at national and international levels – as well as self-correcting measures by market participants. Some aim at improving the standards governing corporate finance and financial markets (accounting, disclosure, etc.); others at getting the incentives right or enforcing better practices (e.g. corporate governance, auditing).

These various efforts make up -- in effect -- a converging agenda among FSF members for strengthening market foundations. Indeed, while the review and the up-grading of key elements of market infrastructure in the US respond to recent high-profile corporate and financial reporting failures, similar initiatives have been launched in a number of other countries for not dissimilar reasons. In particular, the aim of the European Union and of a number of other countries to ensure that, by 2005, listed companies report their accounts using IAS standards is giving impetus to work to strengthen accounting, auditing and corporate governance arrangements.

This de facto convergence of agendas will progressively bring to the fore issues of international coherence. From an international standpoint, a key issue is how much coherence is necessary or desirable, and in what areas. "Coherence" does not require identical standards or practices across countries; it refers to the much more limited objective of ensuring that (1) high-level goals and principles are consistent across countries, (2) the same broad outcomes are being sought, and (3) that market incentives are properly aligned, to produce efficient outcomes. Within these broad parameters, coherence leaves it to national authorities to decide on the approaches, means and mechanisms best adapted to their national circumstances.

In some areas, coordination of policy responses between countries and sectors will be important for the success of country-specific initiatives. Global market interdependence is such that one country's reform efforts may be less effective, or even thwarted unless actions of other countries are consistent. Moreover, in some areas, coordinated action may the only effective means of taking on entrenched interests.

But coherence is not an absolute objective, to be pursued for it own sake. <u>How</u> coherence is achieved has a major bearing on its benefits in terms of market efficiency and stability: where it can be only achieved by lowering average standards to the lowest common denominator, then it is not desirable.

The next section (II) provides a **very summary** diagnosis of weaknesses in market foundations along with recent initiatives to address them. A more detailed diagnosis and review of recent initiatives is found in the Annex to this paper. The final section (III) sets out issues for discussion from an international perspective. It suggests that coherence both inside and between countries is important, and more so in some areas than in others. It notes the importance of auditing and enforcement standards in the reform efforts of different countries -- they seem key to improving market foundations. Finally, it raises the issue of how elected officials, public authorities, regulators, standard setters and market participants can sustain the momentum for reform beyond the current fragile period of the business cycle.

II. Diagnosis and Early Initiatives: much has been done, but there is more to do

The table further on provides an overview of the weaknesses being addressed in the wake of recent corporate failures. The overall story it tells is one of defective **practices** in corporate governance, accounting, audit and disclosure, due to inadequate or weakly enforced **standards**.

Corporate governance standards have been found wanting, particularly in areas of board independence, audit and remuneration committee independence and in the accountability regimes for CEOs and CFOs. Conflicts of interest have extended beyond corporate board-rooms and their committees, affecting the behaviour of financial analysts, rating agencies, financial institutions of different types, institutional investors and various other "gate-keepers" of market integrity.

The U. S. Administration, through a ten-point action plan, and the recently enacted *Sarbanes-Oxley Act of 2002*, together with the SEC, NYSE, and NASDAQ, have launched a major push to strengthen the independence of boards and their various committees, as well as to increase the <u>personal</u> responsibility of CEOs for truthful financial reporting in their companies. The EU is undertaking a thorough review of its corporate governance regimes with the help of a High Level Group of Company Law Experts (HLG) and the OECD is surveying developments in corporate governance among its members to identify lessons to be learned, as well as implications for the OECD *Principles of Corporate Governance*. Finally, steps are being taken to address conflict of interest affecting analysts, investment banks, large integrated financial institutions (with underwriting, investment and research arms) and rating agencies.

Specific **accounting** standards have also been found wanting. For instance, standards on the consolidation of Special Purpose Vehicles (SPVs) are either not demanding or not clear enough; and the same holds for standards dealing with revenue recognition, which have accounted for two thirds of re-estimations of net income. There is much discussion of whether equity-based remuneration schemes in the form of options should be expensed as costs to be deducted from net income. The IASB has already signalled its intention to adopt a new standard requiring that stock options be costed and deducted from net income in financial statements and, among many other things, is working on revenue recognition and business combinations.

Beyond specific accounting issues, there are **overarching** issues about the respective merits of rule-based versus principles-based approaches to accounting and the need for international convergence of accounting standards. FASB and the SEC are publicly committed to moving the U.S. from the current rule-based to a more principles-based approach. And the European Union is committed to adopting by 2005 International Accounting Standards (IAS) for all companies listed in Europe. Other countries - Australia, New Zealand, Singapore and Hong Kong - have decided to adopt IAS as well, some of them earlier. The IASB has a full scale convergence project underway with FASB.

Auditing practice standards have been found deficient as well as inadequately enforced. Several jurisdictions have concluded that self-regulation is an inadequate form of oversight over the auditing profession. The U.S. and Canada have both recently created independent public boards to oversee their audit professions. The UK is reviewing its audit oversight mechanisms, as are other countries. And, at the international level, IOSCO has two drafting groups developing, for early October, guidelines for domestic authorities on auditor independence and auditor oversight.

Both **disclosure** standards and practices have been revealed as inadequate with respect to comprehensiveness (e.g. off balance sheet transactions), timeliness (between reporting period events) and transparency of valuation practices. In the U.S., the SEC and the *Sarbanes-Oxley Act of 2002* have already taken steps to tighten disclosure norms. IOSCO and the Joint Forum have task forces working on transparency and disclosure issues, and the EU along with many domestic authorities are reviewing their disclosure standards.

Conflicts of interest have also been revealed in corporate governance at financial institutions, and notably inside investment banks. A number of countries have announced new codes of behaviour to shore up the independence of financial analysts, particularly when they work for institutions active in underwriting, investment and research.

Finally, there is much effort to strengthen the **enforcement** of standards. Market forces and the checks and balances of corporate governance are the first line of defence in enforcing discipline on companies. But enforcement also takes more direct forms: auditing, market oversight by independent analysts and credit rating agencies; market oversight by regulators and supervisors; external pressure of well informed investors; rules, legislation, and, ultimately, legal recourse and public sanctions.

Recent corporate failures have revealed shortcomings in all of these disciplining mechanisms. Taken together, they can be mutually reinforcing: Deficient corporate management practices can compromise audit committee and remuneration committee independence; lack of audit independence undermines audit quality; poor audits and poor disclosure prevent effective market oversight and supervision. A lack of enforcement weakens practices all around.

To sum up, failings in market foundations are being addressed through self-correction by market participants, actions by domestic public authorities (governments, regulators, supervisors, standard setters, etc.) or by international standard setters (e.g. IASB, IOSCO, IFAC, etc). Changes have already been announced by many parties and jurisdictions, more are coming, and on issues where the best policy response is unclear, work is underway.

Weaknesses in Market Foundations: Key Issues

CORPORATE GOVERNANCE

- Corporate governance codes in general
- Incentives of CEOs to uphold high standards of conduct and business ethics
- Use of equity-based remuneration as managerial incentives
- Relationship of CEO and Board of Directors
- Role and composition of audit committees
- Treatment of whistle-blowers

ACCOUNTING STANDARDS

- Responsiveness of accounting standards to market changes and the needs of investors
- Rules versus principles in accounting standards
- Coherence of national and international accounting standards
- Consolidation of SPVs and other off-balance sheet entities
- De-recognition of assets and liabilities
- Revenue recognition
- Accounting for derivatives
- Accounting for management and employee stock option rewards
- Accounting for pension contributions and obligations

AUDITING QUALITY: STANDARDS & PRACTICES

- Codes of practice and auditor independence
- Oversight of audit profession/enforcement/discipline
- Effects of audit industry consolidation
- International coherence in audit quality standards and enforcement practices

DISCLOSURE AND MARKET OVERSIGHT

- Comprehensiveness of disclosure
- Timeliness of disclosure
- Transparency of valuation assumptions
- Use of pro forma results
- Plain language reporting
- Independence of investment analysts
- Quality of risk assessment and due diligence by financial counterparties
- Quality of rating agencies' work/timeliness of rating decisions
- Disclosure of rating triggers

The Annex provides a more detailed diagnosis and review of initiatives by various domestic and international authorities.

III. Issues for Discussion

For international policy-makers, there are a number of interrelated questions:

1. How far can reforms be left to self-correcting market forces, without the need for public interventions? And how can over-reaction, by markets or public authorities, be prevented?
2. Where does coherence between countries really matter? What issues are better addressed by each country?
3. Where does coherence between reforms in different sectors matter?
4. How to sustain the momentum for reforms?

1. How far can reforms be left to market forces rather than public interventions?

Market competition can trigger a race for better practices, as companies seek to attract capital on more favourable terms. Much competitive self-correction is already happening in the areas of corporate governance, auditing and accounting practices and voluntary disclosure. Since the Enron bankruptcy, many large companies have voluntarily committed to reviewing and disclosing off-balance sheet entities and transactions; deducting equity-based remuneration schemes as costs in their income statement; increasing the separation between audit and consulting services provided by accounting firms; and publishing corporate codes of ethics.

Not only are corporations volunteering commitments to improve their practices, but large investors are banding together in groupings like the International Corporate Governance Network (Calpers, Fidelity, Capital Group, Hermes Pension Management, Barclays Global Investors...) to leverage reforms on the part of the companies whose stock they hold. Such pressure by the more "visible" hand of the market is potentially powerful.

As long as market-driven self-correction amounts to a "race to the top" (i.e. towards best practices) rather than a "race to the bottom", it is desirable and should be encouraged. And if market corrections obviate the need for further regulation and public intervention, that is welcome.

But, there are limits to market based self-correction, perhaps especially with regard to audit quality, disclosure standards, and conflicts of interest arising in corporate governance. A key objective of public policy is to help **lock in** improvements in best practices, e.g. by codifying them, so that they:

- eventually spread to all public companies
- spread faster than would otherwise be the case
- become the norm, the floor, rather than the ceiling for other market participants
- do not give rise to widening discrepancies in behavior.

Locking-in can also be important for preventing undesirable forms of regulatory arbitrage (the competitive search for weaker regulatory regimes). Moreover, market corrections are typically highly cyclical: booms are phases of increasing complacency, followed by busts, retrenchment and over-reaction. Regulatory locking-in can help dampen the cyclical over- and under reactions of market participants.

On the other side, regulatory locking-in can stand in the way of competitive innovations by market participants, since regulators typically lag behind market developments. Regulators are sometimes compelled to reflect in their rules and practices the short-term over-reactions originating with elected officials. Getting the right balance between regulatory locking-in and market self-correction will require constant judgment.

This being said, there is today a window of opportunity to implement needed reforms. This should be seized, given that public attention and market resolve may well weaken as the economy improves and the spotlight moves to other issues. <u>A key challenge is how to maintain the resolve to keep improving market foundations</u>. Broad-based support and urging can help regulators play their role in reducing over-reactions at both extremes of the business cycle. Getting this balance right, between over- and under-reaction, will require on-going dialogue between national and international authorities.

2. Where does coherence between countries really matter? What issues are better addressed by national authorities in each country?

There are three key issues with regard to international coherence in reform agendas:

- where is it needed most?
- how much of it is desirable?
- what mechanisms or processes might best bring it about?

Where is coherence needed?

Corporate governance regimes are steeped in the unique history, institutional heritage and economic/cultural mores of each country. There are however broad common principles and objectives for all countries (e.g. board independence, audit independence, avoidance of conflict of interest, fair disclosure). These are set out in the *OECD Principles of Corporate Governance*, one of the twelve standards and codes deemed essential by the Financial Stability Forum. The OECD, in reviewing by 2004 its existing *Principles*, could usefully make these more explicit and demanding in the guidance they offer.

Coherence in **accounting standards** has become much more pressing as a result of capital market integration. The intention of many countries to adopt IAS in the near term, together with the major convergence project between FASB and the IASB around more principles-based standards should help accelerate international convergence. But this will bring new challenges. Countries that move from rule- to principles-based accounting standards should expect to invest much in tighter corporate governance, auditing standards and audit profession oversight and enforcement in general. Principles create fewer incentives to adjust transactions to fit the rules, but leave more discretion to managers and auditors in deciding how to record transactions and report. Principles will result in accountants and auditors sometimes making mistakes in good faith. Moving from rules to principles will thus place stronger demands on sound market foundations and more sophisticated control mechanisms.

At present, **auditing practice standards** differ considerably from country to country. Audit firms are required by law to abide by national standards of the country in which they operate and the common umbrella provided by the letterhead of global accounting firms conceals large variations in the audit quality of different branches and offices. Notwithstanding the existence of international audit practice standards, there have remained considerable institutional obstacles to convergence on these standards. These issues should be revisited in light of recent market developments.

Oversight of the auditing profession also leaves much scope for international consultation and coordination. There is significant international divergence in the oversight and enforcement of auditing practice standards. Indeed, many countries have no oversight agencies for their auditing sectors. An FEE (*Fédération européenne des experts comptables*) survey observes that this is the case for half of EU member countries. Other jurisdictions continue to rely on self-governance by the audit profession. However, several jurisdictions have recently come to the view that self-regulation is less effective than oversight and enforcement by independent bodies. The FSF attaches much importance to the guidelines on audit independence and oversight of the audit profession, which IOSCO is committed to releasing and disseminating in October 2002.

A consideration that bears on how higher audit quality can be achieved in individual jurisdictions is the increasing concentration of the "first tier" of **global accounting firms** (the former "big five" now reduced to the "big four"). It is too early to understand fully the potential effects of this concentration on audit quality, for example on the ability to practice auditor rotation and discipline the auditing profession. If future court judgments, for instance, were to force the exit of another global accounting firm, the resulting increase in concentration would have a major bearing on all countries. For this reason, the international community may have an interest in seeing develop a second tier of reputable and quality accounting firms able to step into the breach.

The increasing concentration of the world accounting industry is a truly global issue, where both the diagnosis and possible policy responses go beyond national boundaries. There is scope for an international dialogue on these issues.

Finally, global markets do require greater harmonisation of **disclosure standards**. While market pressures, notably through institutional investors, and multiple listings, are helping bring this about, national regulators have a key role to play in areas where pressures for better disclosure are weak or absent.

How much coherence is desirable?

The issue of <u>how much</u> coherence is desirable cannot be divorced from the question of <u>what sort</u> of coherence. Coherence in international standards may be achieved by coalescing around best practices, average practices, or diluting standards to achieve a lowest common denominator acceptable for consensus. Few would consider the latter two, and certainly not the latter form of coherence desirable.

There is room for debate on how much and what sort of coherence is desirable. One view is that regulatory competition between national jurisdictions - expressing different national preferences and market strategies - can have positive effects (a "race to the top"), whereas international harmonisation carries the risk of diluting existing norms towards the lowest common denominator (e.g. mutual recognition agreements between listing authorities with widely different standards). For others, there is a risk that current and pending reforms across FSF countries could reduce coherence, capital market integration and its efficiency-enhancing benefits, thus stimulating regulatory arbitrage on a wide scale. Yet others see the current reform agendas in North America and Europe as a unique window of opportunity to give a new impetus to greater international coherence. These illustrate three possible approaches to coherence: (a) let markets decide how much of it is desirable, (b) intervene only to prevent any reduction in the current degree of international coherence (c) seize now the opportunity to secure greater coherence.

Irrespective of the choices made, sight should not be lost of the real benefits of greater international coherence: More consistent accounting/auditing/enforcement standards across countries would facilitate cross-border comparisons, reduce uncertainty resulting from non-comparable information, leading to more efficient financial flows, and ultimately reducing the cost of capital, while improving its allocation across sectors and companies. And coherence will bring stability benefits as well.

Through what processes or mechanisms?

Market forces alone will trigger some pressures for greater international coherence. Listed companies competing for favourable access to capital have inherent incentives to adopt <u>best</u> practices. But market forces can also take the less desirable form of regulatory arbitrage.

National regulatory authorities also face "competitive" pressures from other jurisdictions, as well as public interest pressures to improve market foundations within their borders. Indeed, domestic, regional and international authorities currently have many public processes at work in the areas discussed in this note. At this stage, new mechanisms are not needed as much as are means by which information exchange and co-ordination among these processes is facilitated.

What issues are better addressed by national authorities in each country?

Each national authority will face interdependencies and trade-offs between reforms in corporate governance, accounting/auditing standards and disclosure policy, reflecting the structure and adequacy of existing arrangements. Countries would gain from sharing lessons with each other on these trade-offs.

For instance, having the right checks and balances in corporate governance systems is a necessary but not sufficient condition for truthful accounting. <u>Personal</u> ethics and <u>internal</u> codes of conduct for CEOs, CFOs and auditors are the first line of defense, which cannot be replaced by external checks and balances in corporate governance systems, which come into play at later stages only. The values which top executives live by, internalise and instill in their employees cannot be replaced by external checks and balances. There may be lessons to be learnt from the early and decisive U.S. actions.

3. Where does coherence between <u>sectors</u> really matter?

Much public attention is presently focused on reform efforts affecting the corporate sector. It is important not to lose sight of the need for reforms in the financial sectors (banking, insurance, fund management, rating agencies notably), which are also coming under strain in the current crisis of confidence.

Questions are being raised about whether investment and commercial banks have been prudent enough in assessing the risks of their corporate counterparties using dubious accounting practices, and, in some cases, whether they assisted companies in making their transactions less transparent. Some large financial firms appear to have facilitated doubtful transactions, with their involvement ranging from general advice to lending and designing specific transactions. In these cases, the reputation of the bank may have implicitly served as an endorsement or certification of the legitimacy of these transactions. The investment bank arms of large financial institutions, in particular, are known for their "deal culture" in which the expectation of fees may encourage compliance with customer requests despite their undesirable side-effects. Their involvement in helping conceal the debt and leverage of their customers impairs risk assessment not only by third parties, but by the commercial lending arms of their parent institutions.

More generally, there are concerns about whether reporting in the financial sector reveals enough about the level of risks faced. A case in point is credit risk transfer activity. Risk transfer arrangements are becoming so complex and opaque that it is difficult for counterparties, let alone regulators, to ascertain who the ultimate risk bearers are. Matters are not aided by the increasing interpenetration of the banking and insurance sector through, for instance, large conglomerates combining insurance and banking activities. There are also worries about how little is known about the extensive linkages between the highly concentrated reinsurance sector and other financial sectors. All these issues affect investor or policyholder confidence and the efforts of various international associations and expert committees (IAIS, CGFS, BCBS and IASB), along with national regulators to address them should be given encouragement.

The increasing interconnectedness between the securities, insurance, banking and fund management sectors suggests the need for greater coordination between different functional standards setting bodies and regulators.

4. How to sustain the momentum for reform?

As is evident from this note (together with the Annex summarising ongoing initiatives in this area), there is much work underway to address the revealed weaknesses in market foundations. This work spans national, regional and international bodies, across different sectors, and in multiple areas, carried out by bodies with relevant expertise and authority.

The central challenges for decision-makers will be to maintain the momentum for on-going reforms to underpin the self-correcting forces of markets, while managing the tension between public expectations of immediate and visible results and the careful work required to build better foundations for the longer term.

There is a real risk that this momentum will falter, either because improvements in the economy cause the public spotlight to turn to other issues, or, in the event of an economic downturn, because of calls for relief.

Broad-based public support will have a part to play in supporting the work of domestic authorities, as well as that of the relevant international standard setters (IASB, IFAC, IOSCO, OECD). Regulators have a key role in locking-in best practices arising from market self-correction and resisting the over- and under-reactions that occur during the business cycle. Finally, market participants, rating agencies, analysts, investment banks, counterparties all have a responsibility to maintain the momentum of market-driven self-correcting actions beyond the very short-term: this will help reduce political pressures for “quick fixes” which do not always do justice to the complexity of the issues at hand.

ANNEX

Addressing Weaknesses in Market Foundations
Detailed Diagnosis and Review of Key Initiatives

Corporate Governance

Corporate governance defines the roles of all parties and sets up checks and balances to ensure that Board Chairmen, directors, CEOs, managers, audit and compensation committees and external auditors fulfil their responsibilities and obligations. Much of it deals with the necessary checks and balances for averting conflict of interest situations where any of the above may put their personal interest ahead of those they are mandated to represent.

Key issues are the accountability of CEOs, the independence of boards from managers, the use of leveraged equity-based compensation schemes or option programs for managers, the independence of audit and compensation committees, and the independence of external auditors.

Initiatives

In February 2002, the U.S. Administration published a ten-point action plan to improve disclosure, auditing and corporate governance. Four out of the ten points concern corporate governance, and more specifically the obligations of CEOs.

U.S. ADMINISTRATION'S TEN POINT ACTION PLAN

1. Each investor should have quarterly access to the information needed to judge a firm's financial performance, condition and risks
2. Each investor should have prompt access to critical information
3. CEOs should personally vouch for the veracity, timeliness, and fairness of their companies' public disclosures, including their financial statements
4. CEOs or other officers should not be allowed to profit from erroneous financial statements
5. CEOs or other officers who clearly abuse their power should lose their right to serve in any corporate leadership positions
6. Corporate leaders should be required to tell the public promptly whenever they buy or sell company stock for personal gain
7. Investors should have complete confidence in the independence and integrity of company's auditors
8. An independent regulatory board should ensure that the accounting profession is held to the highest ethical standards.
9. The authors of accounting standards must be responsive to the needs of investors
10. Firms' accounting standards should be compared with best practices, not simply against minimum standards

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In February 2002, the SEC asked both the NYSE and NASDAQ to review their listing requirements on an urgent basis. Both stock exchanges have already proposed significant changes to their listing requirements concerning corporate governance. Finally, on 30 July 2002, President Bush signed into law the *Sarbanes-Oxley Act of 2002 (H.R. 3763),* which enacts significant changes to corporate governance and auditing oversight.

SARBANES-OXLEY ACT OF 2002

- Creates an independent *Public Company Accounting Oversight Board* to enforce professional standards, ethics and competence for the accounting profession
- Strengthens the independence of firms that audit public companies by having the SEC prohibit the provision of consulting services to audit clients, when these services create conflicts of interest
- Requires CEOs and CFOs to vouch personally for the veracity of their financial statements and provides much stiffer penalties for fraud
- Strengthens disclosure requirements for public companies, notably in the areas of off-balance sheet transactions and insider trading
- Protects the independence and objectivity of securities analysts by directing the SEC to review rules ensuring their independence
- Directs the SEC to undertake comprehensive reviews of corporate governance, the separation of audit and non-audit work, and the role of credit rating agencies
- Increases the resources available to the SEC

In addition, on 28 June 2002, the SEC asked the CEOs of the 945 largest SEC-registered companies to certify, starting on 14 August, the accuracy of their recent annual reports, giving them an opportunity to re-submit them if necessary. And, on 9 July 2002, President Bush created a Corporate Fraud Task Force.

Reviews of corporate governance, in whole or in part, are under way in many other FSF countries. For instance, the UK government has asked for a report on the role and effectiveness of non-executive directors. The Japanese government has recently revised parts of its commercial law code for large joint stock companies, other member countries like Germany and Singapore have recently substantially updated and tightened their corporate governance codes. In France, business associations have completed three major reviews of corporate governance. In Canada, the consolidated federal regulator OSFI will issue corporate governance guidelines for federally-regulated financial institutions this fall, and there are many other efforts under way in other FSF countries. Finally, the EU has launched a major effort to compare, update and improve its members' corporate governance regimes. And, at their May 2002 meeting, OECD ministers expressed their intention to improve corporate governance: the OECD will survey developments in OECD countries on governance in the corporate and financial sectors, with a view to identifying lessons to be learned and the implications for the assessment of the OECD *Principles of Corporate Governance*, which is to be brought forward from 2005 to 2004.

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EUROPEAN UNION (EU)

- The EU recently completed a *Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States*
  - This study was reviewed by a High Level Group of Company Law Experts (HLG), chaired by Professor Jaap Winter
  - It will be published later in October 2002
- On 30 September 2002, EU governments and the European Commission discussed the study and the recommendations of the HLG
- They will draw up an action plan on the reform of national rules dealing with executive pay and audit practices. They will also discuss the creation of a regulatory body or a committee of national regulators to oversee corporate governance across the EU

Issues under discussion

There is much debate about issues affecting board independence. Should the jobs of Chairman of the Board and CEO be split (an approach generally favoured in Canada, continental Europe and the U.K, for instance) or joined together (the most frequent case in the U.S.)? The proportion of independent directors in the composition of boards does not suffice to ensure independence: these directors must also be effective, which in turn raises questions about the competencies they should hold and the need for continuing education for directors in the fast evolving developments in financial and other markets.

Finally, compensation issues are at centre-stage. The use of leveraged equity-based compensation systems for senior managers is attracting increasing criticism for causing them to focus on the short-term value of company stock instead of the shareholders' interest in long term stock value and company growth. More broadly, shareholders and institutional investors are increasingly critical of executive compensation schemes, which are not only too rich in their view, but more and more tenuously linked to job performance.

Accounting Standards

There are three **overarching** issues concerning accounting standards: greater responsiveness to market changes and the needs of investors; the case for principles versus rules in accounting; and the potential for greater international coherence of standards. In addition, there are specific issues about the accounting treatment of **particular types of transactions** (SPVs, de-recognition of assets, recognition of revenue, stock options, derivatives, pension obligations, etc.)

Initiatives

On responsiveness, the SEC has committed to exercising much greater oversight over the FASB project agenda and completion deadlines. FASB will also be accelerating its work on many contentious specific accounting issues referenced above. Many other member countries, involving their various accounting professional associations, are also launching reviews of their accounting standards in these areas.

On rules versus principles, the new FASB chairman has committed publicly to take aggressive action to move U.S. GAAP from the traditional detailed rules to more principle-

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based standards. As Europe moves to adopt IAS principles by 2005, many observers predict that its principles however could be pushed by market forces into becoming more precise and more "rule-like".

With respect to coherence, there are two convergence agendas that hold out prospects for further harmonisation of world-wide accounting standards:

- in the U.S., FASB has committed to accelerate the convergence between principle-based IAS and U.S. GAAP; and
- the EU will, in a September directive, commit its members to the goal of mandatory IAS accounting for all EU-listed companies by 2005. And several other countries notably in the Asia-pacific region have volunteered similar commitments.

The move to IAS accounting for all of Europe is a considerable challenge for national and international authorities. The IASB has a major commitment to having all necessary IAS in place for the EU 2005 deadline, as well as reviewing its standards in light of lessons from recent corporate failures. And other international standard setters (IOSCO, IFAC, etc.) have made similar commitments to review their own norms.

INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB)

- Committed to having comprehensive International Accounting Standards in place for the target date of 2005, by which all companies listed in Europe must present their accounts using IAS.
- "Our goal is to identify the best standards around the world and establish a body of standards that build on the best...we call that convergence to the highest level"
- Has launched priority projects on:
  - business combinations (e.g. consolidation)
  - de-recognition
  - revenue recognition
  - derivatives
  - stock options
  - pension accounting
- Is working with FASB on a full-scale convergence project between U.S. GAAP and International Accounting Standards (including pension accounting)

The IAS 2005 deadline will also require all EU members to accelerate their transition from national to IAS standards. The move to IAS standards involves much more than just changes in accounting principles: equally important are improvements in auditing standards and enforcement practices (see next section).

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EUROPEAN UNION (EU)

- Speedy adoption, this year, of the Proposed Regulations requiring the use of IAS by EU listed companies by 2005
- Continuation of the dialogue with US authorities to encourage their acceptance of IAS financial statements prepared by listed EU companies for listing within the US (without reconciliation to US GAAP from 2005 onwards)
- EU support for global convergence through the IAS process on important accounting issues such as the treatment of financial instruments, share-based payments and off-balance sheet financing schemes
- Before Summer 2002, publication by the Commission of a second consultative document on *Regular Reporting* (e.g. quarterly reporting, on-going disclosure obligations)

Issues under discussion

The overarching issue of choosing between “rules versus principles” is far from clear-cut in real life. There are good reasons for moving from rules to principles: having to live by the spirit and intent of a principle is often more demanding than abiding by the narrow, technical letter of a rule. On the other hand, rules are easier to enforce and to litigate. The European preference for principle-based accounting will not escape pressures to make the principles more precise, more enforceable, and hence, more rule-like. Likewise, U.S. attempts to move closer to principles will most likely retain some rule-like components, when these are found to create beneficial accounting discipline.

Many of the specific accounting issues (SPV treatment, de-recognition of assets and liabilities, recognition of revenues, accounting for derivatives, accounting for leveraged equity-based remuneration and pension accounting) are likely to give rise to differences in approach between countries or regional blocks of countries, and hence raise issues of international coherence. For instance, in the case of SPVs, the U.S. tends to use percentage ownership thresholds (which it will likely raise) to decide whether an entity can be moved off balance sheet, whereas Europe favours more qualitative “effective control” tests. Europe and the U.S. also appear to hold different views on accounting for stock options. International coherence will be a challenge on these issues.

Auditing Quality: Standards And Practices

There are four broad issues in the area of auditing:

(i) ensuring that <u>quality standards</u> are high enough and consistent across countries

(ii) ensuring that auditors are sufficiently <u>independent</u> that the quality of their work is not compromised (this means maintaining independence between external auditors and management, by for instance avoiding conflicts of interest between <u>auditing</u> and <u>consulting</u> work done for the same client)

(iii) ensuring effective <u>oversight</u> and <u>enforcement</u> over the auditing profession

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(iv) dealing with the effects of increasing audit industry consolidation on auditing practices

Initiatives

With respect to auditing standards, IFAC is active at two different levels. At the public interest level, it plays a key role in the promulgation of International Standards of Auditing and supporting the International Auditing Practices Committee (IAPC), subject to the oversight of an independent review board. At the professional level, IFAC has also created a Forum of Firms (FOF) to improve the standards and consistency of audits of trans-national entities around the world and is committed to implementing its IFAC compliance regime for all its members. And the Fédération européenne des expert-comptables (FEE), working closely with IFAC and its International Auditing Standards Committee, is calling for Europe to commit much more strongly to the International Standards on Auditing, under the coordination of a forum of European national auditing standard setters.

With respect to auditor independence, the SEC has tabled tighter rules governing all aspects of auditor independence, including mandatory auditor rotation (after 7 years) and guidelines on what types of non-auditing contracts can be entered with an auditing company without jeopardizing audit independence. IOSCO is preparing for early October guidelines for auditor independence. Other jurisdictions, like Singapore for instance, have imposed auditor rotation for their banks, but rely, like Germany, on the less demanding "partner- rotation" (within the same firm) for other companies.

The Review Board and Ethics Standards Board of the UK Accountancy Foundation is also working on the issue of auditor independence, as is the Canadian Institute of Chartered Accountants (CICA) and many others.

With respect to oversight of the accounting profession, the *Sarbanes-Oxley Act of 2002* will create in the U.S. an independent *Public Company Accounting Oversight Board* to oversee the audit profession. This Board will have the power to enforce audit codes of ethics and quality standards, review audit work and potential conflicts of interest, impose sanctions on auditors and issue subpoenas. Canadian authorities announced on 17 July 2002 the creation of a new and independent *Canadian Public Accountability Board* (CPAB) to set and enforce auditing standards on publicly listed companies. And the U.K. government has publicly committed to reviewing the adequacy of its oversight arrangements over the auditing profession.

On the international front, the EU is to adopt by September 2002 a new directive governing statutory audit, public oversight of auditing firms, the role of audit committees, and a possible code of ethics to guide the auditing profession in the EU. And IOSCO has asked a working group to set out, for early October, guidelines on the oversight of the auditing profession.

Finally, with respect to trends towards audit industry consolidation, IOSCO is reviewing the implications of these for competition, audit quality, prospects for audit rotation and the ability to discipline the industry.

Issues under Discussion

Both audit quality and the separation of audit from consulting work raise issues of international coherence. The U.S. has, until recently, generally allowed auditing firms to offer non-audit contracts to companies they are auditing. France has tended to prohibit such practices unless explicitly specified. Others, such as Germany, restrict non-audit work by imposing limits on the non-audit fees that can be collected from an audit firm.

Annex

There are also international divergences in auditing standards and enforcement mechanisms. Accountancy firms are required by law to apply national standards when doing the audit of a firm in a particular country, except in some cases of trans-national audits, where there are contractual agreements to use other standards. Not only are differences in standards between countries considerable, but so are differences in the quality of auditing inside accounting firms: global accounting firms are loose "federations", which lend their name to partnerships all over the world, whose practices may differ considerably.

Moreover, audit standards, in the last resort, also need to be backed up by a strong external enforcement apparatus. There is evidence that **enforcement** standards vary even more than **auditing** standards across countries: the FEE found that half of European countries have no oversight system at all over their audit practices or securities markets. That is why the FEE is spearheading a major push to extend audit enforcement mechanisms to European countries that don't have any, while bringing enforcement standards closer together (essential to ensure that mutual recognition of prospectuses does not cause norms to drift towards the weakest standard).

Finally, it is acknowledged that moving accounting standards from rules to principles will increase the discretion left to managers and auditors. In turn, this greater discretion will increase the burden placed on audit quality controls and enforcement to ensure that it is not abused.

Disclosure Practices And Market Oversight

There are three key sets of issues here, concerning:

(i) the comprehensiveness, timeliness, transparency and clarity of disclosures

(ii) the increasing use of *pro forma* reporting and press releases instead of reports prepared according to accepted accounting standards, and

(iii) issues of analyst independence and quality of rating companies' assessments

Initiatives

In the U.S., the administration, the SEC, NYSE, NASDAQ, along with the *Sarbanes-Oxley Act* have made many proposals and decisions to increase the quantity and quality of disclosure. Companies are expected to:

- have their CEOs and CFOs personally vouch for the veracity of the financial reports they submit
- provide more information about tends affecting their business (in the "Management Discussion" section of their reports)
- identify accounting policies crucial to the presentation of their accounts
- provide investors with a better measure of the sensitivity of financial results to methods, assumptions and methodologies
- disclose more about relations with unconsolidated entities and insider trading
- make greater use of "plain English"

With respect to *pro forma* reporting, the SEC, the NYSE and IOSCO have all issued cautionary advice on their use. The NYSE in its 6 June 2002 proposals suggests that "the SEC require companies, in all public or shareholder communications, to report complete GAAP-based financial information before any reference to *pro forma* or "adjusted" financial information".

Issues under discussion

The independence of investment analysts has been an acute issue in large integrated financial companies active in underwriting, investment and market analysis. The SEC launched on 25 April 2002 a formal inquiry into the potential conflicts that can arise between research and investment banking. On 8 May 2002, it approved proposed changes to the NASDAQ and NYSE rules addressing conflict of interest among research analysts, which took effect on 15 July 15 2002. And, on 28 July 2002, the National Association of Securities Dealers (NASD) banned practices allowing brokers to make improper gains from IPOs (e.g. "spinning", "laddering" and quid pro quo agreements). The U.K. Financial Services Authority (FSA) recently tabled a discussion paper on analyst independence and many other countries have been addressing these issues as well.

Finally, there are issues about the quality of rating agencies' work and the timeliness of their rating decisions. The EU and the U.S. Securities Exchange Commission are each doing an assessment of recent credit ratings and the case for regulatory intervention in this sector. Standard & Poor's and Moody's have both released major surveys of "rating trigger" clauses to determine whether greater transparency and disclosure is warranted for these triggers, which can cause liquidity crises and destabilizing effects.